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PALESTINIAN MINISTRY OF FINANCE AUDIT CAPACITY BUILDING PROJECT PHASE II

FINAL REPORT FOR EXTENSION PHASE ENDING JUNE 30, 2005

31 August 2005

This publication was produced for review by the United States Agency for International Development.
It was prepared by Emerging Markets Group, Ltd.



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Submitted by:

Emerging Markets Group, Ltd.

Submitted to:

USAID / West Bank & Gaza

Contract No.:

PCE-I-00-99-00008-00

Task Order No. 822

SEGIR Financial Services

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ACRONYMS

DG	Director General
EMG	Emerging Markets Group, Ltd.
GPC	General Petroleum Corporation
IT	Information Technology
MIS	Management Information Systems
PA	Palestinian Authority
USAID	United States Agency for International Development
VAT	Value-added Tax
WCO	World Customs Organization



EXECUTIVE SUMMARY

This report covers the activities of the Palestinian Ministry of Finance Audit Capacity Building Project – Phase II during a project extension phase from May 1, 2004 to June 30, 2005. Activities during the original project term from May 1, 2003 through April 30, 2004 are covered in a report submitted to USAID in 2004. During this extension period, EMG undertook several initiatives that improved financial management capabilities and accountability at the General Petroleum Corporation, a public sector entity under the control of the Ministry of Finance, and improved operational efficiency at the Department of Customs & Excise.

The overall objective of the Project was to develop the financial management capacity of the Palestinian Authority (PA) with the goal of improving the credibility and integrity of the PA's public finance system. During the original project term, the EMG team worked towards achieving this goal by strengthening financial controls at the Ministry of Planning and the Ministry of National Economy. The EMG team documented process flows, identified internal control deficiencies and recommended improved processes to mitigate these risks, such as instituting an explicit segregation of duties among staff in a given Finance Department or utilizing standard forms for financial transactions. EMG also provided training to financial and administrative personnel in audit skills, basic computer usage, and improved management. In addition, the team provided technical assistance to the General Petroleum Corporation helping Finance staff gain a clear handle on their financial reports and clean up the historical balance sheet.

Extension phase activities grew out of these areas of support. During the extension phase, EMG continued to provide focused accounting support to the General Petroleum Corporation but also introduced an improved financial control regime and implemented extensive organizational improvements to strengthen the GPC's financial management capability. Extension phase activities were designed to address exceptions listed in an External Auditor's report for the General Petroleum Corporation, primarily dealing with poor financial controls. The EMG team provided technical assistance to strengthen the capacity of the Finance Department by implementing improved financial policies and procedures, creating a revised organizational structure for the Finance Department, writing job descriptions for staff, and providing comprehensive training on accounting skills, basic computer usage, and management. As a direct result of project assistance, revenue increased at the GPC by more than \$100 million (or 180%) over a one-year period.

Also during the extension phase, the EMG team developed detailed recommendations for organizational improvements at the Department of Customs & Excise. The EMG team developed an improved organizational plan for the department that, when implemented, will facilitate more efficient and effective operations. The team developed a new organizational chart for customs operations in both the West Bank and Gaza, revised department description and position descriptions for 380 Customs staff. In addition, the EMG team met with officials of the World Customs Organization (WCO) in Brussels to discuss action steps the PA must take to become a member of this international customs body.

Extension Phase Results

ACCOUNTING SUPPORT AND ORGANIZATIONAL IMPROVEMENTS AT THE GPC

- EMG's assistance to the GPC has led to improved customer billing and receivables, improved accounting records for management and audit and a decrease in illegal cross-border petroleum transactions. In 2003, prior to project assistance, revenues from the GPC constituted 7% of the Palestinian Authority budget (or US\$105,122,000). By the end of 2004, as a direct result of project assistance strengthening internal controls and financial management, GPC revenue constituted 22%



of the PA's total budget at US\$208,204,000. This increase of US\$103,082,000 amounts to a 180% increase in GPC total revenues between the years 2003 and 2004 as a result of improved financial management and greatly reduced opportunities for the misallocation of public funds.

- EMG enhanced petroleum procurement and billing processes, identified significant balance sheet items for resolution, reformed financial management, introduced a segregation of duties among staff in the Finance Department, and rationalized financial processes. Increases in efficiency at the GPC have resulted in greater revenue capture and a significant decrease in revenue "leakage."
- From January through June 2005, EMG has provided more than 150 person-days of on-the-job financial and administrative training to staff in the Finance Department at the GPC.

MODERNIZATION OF THE CUSTOMS & EXCISE DEPARTMENT

- EMG assessed and recommended improvements to the existing organizational structure of the Customs & Excise Department. In the existing organizational structure, there are 31 positions reporting directly to the Director General (DG). In the recommended organizational structure, only six positions report to the DG; this streamlining of reporting allows for a much more efficient organization.
- EMG developed position descriptions for 380 employees and detailed functions for five divisions, 36 sections and 21 units.
- Provided training and conducted workshops on recommended organizational improvements. Met with 14 separate departments and regional offices (Jericho, Ramallah, Gaza) to provide tutorial on new structure. Conducted workshop to present revised structure to heads of departments with more than 25 people in attendance, including the Deputy Minister of Finance, Dr. Jihad Al-Wazir.



CUSTOMS & EXCISE

During an extension period beginning in January, 2005, the Palestinian Ministry of Finance Audit Capacity Building Project began a new phase of work with the Department of Customs & Excise. Over a six-month period, the Project provided recommendations to restructure the Department, developing a revised organizational chart for the department with new department and job descriptions. Once implemented, this new organizational structure will contribute to the efficiency and effectiveness of the Customs & Excise Department, as every employee will understand their roles and responsibilities and reporting lines will be clear and streamlined. In addition, the team held meetings with officials of the World Customs Organization (WCO) in Brussels to identify accession requirements and supported the Palestinian Authority with its ongoing customs coordination talks with the Israeli Customs Administration.

Revised Organizational Structure. The EMG team developed a revised organizational chart for the Customs & Excise Department. In the existing organizational structure, there are 22 departments with 83 sub-divisions and 31 positions reporting directly to the Director General. Many functions overlap and reporting lines and lines of authority are unclear. In the recommended structure, only six positions report to the Director General and the structure is streamlined to include five divisions, 36 sections and 21 units. The project team developed descriptions of the functions for each division, section and unit at the Department. A major benefit of the new structure is that principal functions have been clearly allocated among the five major functional departments: Executive Management, Gaza Operations, West Bank Operations, Security and Administration. In the original structure, the responsibility for management of revenue is divided among multiple departments which can lead to opportunities for the misallocation of revenue. The new structure consolidates revenue under one responsible department.

Job Descriptions. The team developed job descriptions for the 380 new positions created under the revised structure. Previously the Customs & Excise Department had no job descriptions for any position, which led to the frequent overlap of functions, unclear responsibilities, competing authority and thus less efficient performance among the employees. Now each position in the new structure has a defined job description which clearly states the position title, reporting lines, level of responsibility, position task and required qualifications. This will enable the Directorate to increase revenues through better performance among the staff and to efficiently achieve its goals.

Accession to the World Customs Organization and Coordination with the Israeli Customs Authority. The Project team also discussed steps to be taken for Palestine to accede to the World Customs Organization (WCO). A project consultant met with WCO officials in Brussels who indicated that Palestine's membership would need to be sponsored by the Government of Israel, due to Israel's political control over Palestinian foreign affairs. This information and further details were communicated to the Director General for Customs & Excise. The Director General and a member of the project team then met with U.S. Department of State officials in Washington, DC, to discuss WCO accession further. The Project team also assisted the Director General to maintain clear and open lines of communication with his counterparts in the Israeli Customs Administration. For example, the Project team drafted a letter on behalf of the Director General for Customs & Excise to the Israeli Customs Authority announcing the Palestinian Authority's intent to seek accession to the World Customs Organization and outlining the motivations for doing so.



GENERAL PETROLEUM CORPORATION

In June, 2004, the project team began a new program of technical assistance at the General Petroleum Corporation (GPC), building on previous project work there, focused on implementing proper financial controls within the Finance Department of the General Petroleum Corporation. The introduction of internal controls and financial procedures during the extension period addresses 13 of 25 major exceptions listed by Talal Abu Ghazaleh & Co., the external auditor for the GPC, in their draft audit report for the fiscal year ending 2002. By putting into operation these internal controls, the GPC is now able to produce more reliable financial statements which we expect will be noted in a new audit opinion from the external auditors in 2006. However, we do not believe the GPC will receive an unqualified opinion after only one year of technical assistance due to the large number of audit exceptions. We believe that additional technical assistance is required to work through the remaining audit exceptions from the external audit report and bring the GPC to an operational state where they may be able to secure a qualified audit opinion.

Recruiting a Finance Manager. The team was asked to interview candidates for a Finance Manager position at the General Petroleum Corporation. The Ministry of Finance concurred with EMG's recommendations and selected the candidate receiving the best evaluation from the EMG evaluation panel. The project team then delivered a comprehensive training course on proper methods of financial management to the new Finance Manager. This course included topics on Financial Accounting Systems, Managing Income Processes and Internal Controls. This training enabled the Finance Manager to understand the existing financial systems and controls, identify the weaknesses and consider recommendations to implement a more effective and efficient finance function.

Cut-off Date for Accounts. The Project team reached an agreement with the GPC management on a cut-off date for accounts. Prior to Project assistance, the Finance Department did not close accounts on an annual basis, resulting in the inability of the Finance Department to present a clear financial picture of the GPC. The accounts contained a number of bad debts and receivables that may never be collected and the GPC continued to carry forward these balances. Thus the financial statements were artificially inflated due to the carry over of unreal accounts receivable amounts. The cut-off date allows the Finance Department to have a clean start with more accurate financial information and an opening balance that reflects a realistic financial position. The cutoff date was agreed to be effective on December 31, 2004. All accounts going forward have been maintained in accordance with International Financial Reporting Standards (IFRS). The main benefit of this important agreement is that the numbers are now more reliable and this addresses the external auditor's qualifications regarding accounts receivable and carry-forward balances (including assets, bank accounts, etc.).

Revised Organizational Structure for Finance Department. The team developed a revised organizational structure for the Finance Department and developed job descriptions for seven positions within the Finance Department. Previously, the GPC had no job descriptions, and consequently no explicit segregation of duties among the finance department, which created a major weakness in internal controls and was noted as a major qualification on the external auditor's report. For example, one person was in charge of receipt, custody and authorization of funds but these functions should be separate under even the most basic segregation of duties. Our team worked closely with the Managing Director of the GPC to develop and implement seven position descriptions for Ramallah-based GPC staff and for Gaza staff, including those in the Na'aleen warehouse. The job descriptions were developed so that duties are explicitly divided among different people to reduce the risk of error, manipulation or misallocation of funds.

Introduction of Standard Forms for Financial Transaction. The team developed eight standard forms to be used for the procurement and inventory processes. Previously, the finance department had no standard forms for major financial processes. Without standard forms, there was no proper authorization



for these transactions and a lack of supporting documentation which has led to overspending or spending on unnecessary purchases. According to the needs of the Finance Department, the Project team developed the following standard forms: Basic Information about Suppliers, Purchase Request Form, Price Offer Request Form, Price Offer Analysis Form, Purchase Order Form, Receipt Voucher Form and Stock Card.

Development of Excel-Based Management Databases. In order to facilitate more efficient management of sales, deliveries and inventory, the team developed several Excel databases to allow the GPC to efficiently manage petroleum sales by coupons, manage deliveries, and to reconcile and match deliveries from the Israeli petroleum supplier, Dor, to actual distribution to gas stations throughout southern Gaza. This assistance addressed deficiencies that were listed as major exceptions in the external auditor's report.

Risk and Control Worksheets. The team developed risk and control worksheets for several of the highest risk financial processes at the GPC: Purchase of Petrol through a Purchase Request, Receipt of Petrol, Receipt of Petrol Sales by Checks or Bank Transfers and Sales of Petrol. Previously, the GPC did not have any documentation on the inherent risks associated with these processes. Since there was no awareness of inherent risks in the business processes, there were no controls in place to mitigate those risks to an acceptable level. Now, the risk and control sheets developed by the team specify each activity within the process, the risks associated with it and the controls that should be in place to mitigate those risks.

Balance Sheet, Trial Balance, Revised Chart of Accounts. At the request of the Minister of Finance and Management of the GPC, the project team prepared a financial report for the year ending December 31, 2004. The GPC is currently using a version of a local accounting system (Bisan) in which they created separate accounts for sales & purchases and therefore separate trial balances for each. The project team reconciled these balances into one proper trial balance and then issued un-audited financial statements. As a result of analyzing the trial balance of the GPC, the project team found that the chart of accounts that is used is inappropriate and does not comply with established standards which results in inaccurate financial reporting. A new chart of accounts is being developed but is not expected to be implemented before the year 2006.

Training Needs Assessment and On-the-Job Training. The team conducted a training needs assessment among GPC staff engaged in the finance function and identified critical areas for further training, including Accounting using International Financial Reporting Standards, Internal Controls, Budgeting, Microsoft Office (Excel, Word, PowerPoint and Outlook) and Methods of Financial Analysis. From January to June 2005, EMG provided more than 150 person-days of on-the-job financial and administrative training to staff in the Finance Department at the GPC.

Financial Policies and Procedures Manual. In the final stage of its technical assistance at the GPC, the team developed and disseminated a new Financial Policies and Procedures Manual. This manual covers Standard Forms, Records and Accounts, Fuel Coupons, Procurement according to the Ministry of Finance Policies and Procedures, Sales, Payments for Goods and Services, Sales by Coupons, Financial Reporting and Budgeting. Prior to project assistance, the GPC had no clear written financial policies and procedures that apply to the GPC and that are accessible and easy to use. The new manual will ensure that management completes their collective financial duties under the least amount of risk. The manual will serve as an authoritative guide and the basis for financial accountability, Ministry of Finance compliance and effective financial decisions.

Notable Results at the GPC

- Revenue increased by more than \$100 million in one year. In 2003, prior to project assistance, revenues from the GPC constituted 7% of revenue to the Palestinian Authority budget (or US\$105,122,000). In 2004, as a direct result of project assistance strengthening internal controls and financial management, GPC revenue constituted 22% of the PA's total revenue (US\$208,204,000). This



increase of US\$103,082,000 amounts to a 180% increase in GPC total revenues as a result of improved financial management.



RECOMMENDATIONS

Based on our experience and the significant results we were able to achieve at both the General Petroleum Corporation and the Customs & Excise Department in a relatively short timeframe, we believe that further activities at these institutions would have a major developmental impact for the Palestinian Authority, improving the efficiency and effectiveness of revenue collection and strengthening accountability and financial management. These two entities contribute fully 90% of non-donor revenue to the Palestinian Authority's budget, and it is therefore of critical importance that there are sufficient controls in place to ensure accountability.

Strengthening the efficiency and effectiveness of Customs will lead to increased revenue collection. Modern Customs administrations are increasingly focusing on trade facilitation and border security, not simply on revenue collection. Although the Palestinian Customs & Excise Department will remain the single most important source of revenue for the Palestinian Authority, continued assistance with Customs Modernization should place increasing emphasis on trade facilitation, especially if Palestinian Customs agents are able to mobilize to border posts in Jericho or Gaza. A more efficient Customs administration will also promote border security for citizens on both sides of the border, be they Palestinian, Egyptian, Jordanian or Israeli.

Improvements in financial management, transparency and accountability at the GPC similarly contribute to increased revenue collection for the Palestinian Authority, but also, importantly, reduces opportunities for the misallocation of public funds that had reportedly gone on within the General Petroleum Corporation prior to project assistance. For example, the \$100 million increase in GPC revenue after only one year of project assistance suggests that large amounts of public funds had been systematically siphoned off for unknown purposes. In terms of the viability of the PA, it is important to capture these funds so that they may be used for public purposes, such as payment of public sector employees' salaries on a monthly basis, or for the provision of badly needed social services.

Our further recommendations for continued technical assistance include:

Customs & Excise:

- Implementation of organizational structure & position descriptions developed by EMG in January – June, 2005;
- Customs modernization diagnostic assessment based on World Customs Organization standards;
- Training and capacity building in relevant topics;
- Assistance with Customs coordination (“mutual administrative assistance for the proper application of Customs law and for the prevention, investigation and combating of Customs offences”) with neighboring Customs administrations including, especially, with the Israeli Customs Administration;
- Appropriate IT/MIS systems implementation.

General Petroleum Corporation:

- Continuing to work through external audit exceptions;
- Cleaning up the historical balance sheet and bad debt recovery;
- Implementation of an appropriate and integrated financial management system;
- Anti-smuggling initiative;
- Training on international financial reporting standards, professional ethics and integrity, information technology.